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Oil and gas producers industry developments - 1992; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Oil and Gas Producers Industry Developments—1992

Update to AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of oil and gas producers with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

The oil and gas industry continues to be affected by a number of economic, political, and regulatory factors. Economic recession, continuing concern for the environment, the push for energy conservation, the disintegration of the Soviet Union, and abnormally warm winter weather all have had an influence on the economics of the industry.

During 1992, the economics of the domestic oil business worsened, while those of the natural gas business improved substantially. While the price of crude oil surged upward at one point when Saudi Arabia assented to new Organization of Petroleum Exporting Countries (OPEC) production quotas, recent prices have declined to levels that are somewhat lower than those of last year. All the while, natural gas prices have risen to their highest levels in years — primarily as a result of refusal by a number of exploration and production companies to sell at low price levels, colder than usual spring weather in certain regions of the country, and concern over the replacement of production capacity lost when Hurricane Andrew destroyed or damaged a number of drilling platforms in the Gulf of Mexico in late August.

Although natural gas prices generally have been lower than oil prices in recent years, the surge in natural gas prices is likely to affect demand negatively as more and more consumers turn to lower priced oil. Demand for natural gas is lower now than it was a decade ago and is likely to move even lower.

Even with its outdated technology, the Commonwealth of Independent States remains the largest oil and gas producer in the world. In the past, its reserves were dedicated to meeting the needs of the former Soviet Union and its satellites. However, with the end of the Cold War, the industry is opening to western investment for the first time in its history. Western analysts have long recognized the potential that lies in further development of the industry in the Commonwealth of Independent States and many U.S. companies are actively pursuing business opportunities there. Nonetheless, major obstacles abound. While efforts are being made to privatize the former Soviet enterprises, there is still a general lack of understanding of profit-oriented business structures. Physical limitations exist as well — for example, there is no distribution system in place to allow oil and gas to flow from former Soviet regions to the world markets. Thus, while opportunities are plentiful, most of the opportunities for U.S. companies are in the long-term.

Regulatory Developments

Environmental Cleanup Costs

Environmental issues are a significant concern for oil and gas producers, many of whom face exposure to significant amounts of environmental cleanup costs. Such issues relate to both upstream and downstream operations. *Audit Risk Alert—1992* includes a detailed discussion of accounting and auditing issues related to such costs.

FERC Order 636

The Federal Energy Regulatory Commission (FERC) approved the issuance of its natural gas pipeline restructuring rule (Order 636) on April 7, 1992. The rule should provide all segments of the natural gas industry with the regulatory certainty to finally establish a nationwide competitive gas market. While FERC Order 636 actually applies to the natural gas pipeline industry, it may have an indirect effect on oil and gas producers as well. Oil and gas producers often enter into contracts to buy space on pipelines. Such contracts may result in commitments that producers should disclose in the notes to their financial statements. Auditors should consider the adequacy of disclosures of such commitments. Evidence that such disclosures are necessary may come to light as auditors review contracts between producers and pipeline owners.

Audit Issues and Developments

Estimated Reserves

The reliability of reserve estimates is a key consideration in many aspects of accounting for oil and gas producing activities. Reserve estimates have a direct impact on the calculation of depreciation, depletion, and amortization as well as on ceiling and impairment tests. In addition, some companies with bank debt and other forms of long-term borrowing may be subject to various debt covenants that are based on the value of oil and gas reserves. Such covenants may stipulate, for example, that if the value of the reserves were to fall below a certain level, the entire debt or a part thereof may be callable in the current year. Auditors should review debt covenants for such matters and consider the effect of reserve valuations and debt restrictions. Auditors should be alert to matters subject to "events of default" and, if necessary, examine written waivers from lending institutions.

In assessing the reliability of reserve estimates, auditors should consider whether qualified and reputable petroleum engineers have been involved in determining reserve estimates and should evaluate the nature, completeness, and accuracy of the data used to develop the reserve estimates.

Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 69, *Disclosures about Oil and Gas Producing Activities,* sets forth requirements for a comprehensive set of disclosures for oil and gas producing activities. The Statement also requires publicly traded enterprises with significant oil and gas producing activities to disclose prescribed supplementary information that includes data about their reserves. SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AICPA Professional Standards, vol. 1, AU section 9558), provides guidance to auditors regarding the procedures they should apply to required supplementary information and describes circumstances that require reporting on such information.

New Cost Centers

Many domestic oil and gas exploration and production companies use the full cost method to account for expenses of exploratory activities in foreign locations (new cost centers). In such circumstances, auditors should carefully evaluate the propriety of deferring costs for new cost centers when the outcome of a field, or concession as a whole, has not been determined. Auditors of publicly held registrants should note that rule 4-10 (i)(3)(ii)(A) of Regulation S-X states that any dry hole costs incurred should "be included in the amortization based immediately upon determination that the well is dry." Auditors should consider reviewing analyses of costs being deferred as well as the results of the exploration activities in assessing the propriety of costs deferred. If results are favorable, an extended deferral may be appropriate; however, if results are unfavorable, continued deferral of the cost may not be justifiable.

COSO Report on Internal Control

In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report *Internal Control—Integrated Framework.* The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management's reporting on internal controls over financial reporting.

The full report consists of four volumes: "Executive Summary" provides a high-level overview; "Framework" defines internal control and describes its various components; "Reporting to External Parties" provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and "Evaluation Tools" provides material to help in evaluating an internal control system.

The four-volume set (No. 990002CL) costs $50; the "Executive Summary"

(No. 990001CL) is available individually for $3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department (see order information on page 11).

Accounting Developments

Impairment of Oil and Gas Properties

Issues regarding the impairment of long-lived assets have surfaced with increasing frequency in recent years. Because of the long-term and uncertain nature of oil and gas exploration and production activities, such issues are especially relevant to entities with oil and gas producing activities.

Generally accepted accounting principles require that capitalized costs be subjected to a "ceiling test." The Securities and Exchange Commission (SEC) staff has indicated a position that for entities using the successful-efforts method of accounting for oil and gas properties, total capitalized costs, as a minimum test, may not exceed future undiscounted after-tax net revenues on a world-wide basis. For entities that use the full-cost method, rule 4-(10)(i)(4) of Regulation S-X requires that for each cost center, capitalized costs, less accumulated amortization and related deferred income taxes, shall not exceed an amount (the cost center ceiling) equal to the sum of (1) the standardized measure of discounted future net cash flows computed in accordance with the provisions of paragraph 30 of FASB Statement No. 69; plus (2) the cost of properties not being amortized pursuant to paragraph (c)(3)(i) of rule 4-10(i)(4); plus (3) the lower of cost of estimated fair value of unproven properties included in the costs being amortized.

The SEC staff also indicated a position that the ceiling test should be applied using current prices at interim periods as well at year end. The SEC staff has rejected filings in which registrants used estimated annual prices in applying interim period ceiling tests because of the subjective nature of the process used in estimating such prices.

Auditors should review the components of the cost-ceiling computation to determine whether they are in accordance with prescribed guidelines.

Hedging of Oil and Gas Production

From time to time, oil and gas producers hedge or speculate by entering into energy futures contracts or options on such futures contracts. In order for futures contracts to qualify as hedges in accordance with FASB Statement No. 80, *Accounting for Futures Contracts*, there must be a high correlation between the price of the product being hedged and the market value of the futures contract. However, certain futures contracts (for example, natural gas futures traded on the New York Mercantile Exchange) do not always track price movements of natural gas delivered in certain regions of the country, especially during certain seasons or at certain points during the life of futures contracts. Auditors should consider whether management's designation of futures contracts as hedges is appropriate in light of the criteria set forth in FASB Statement No. 80.

As they evaluate the propriety of presentation and disclosure of hedging activities in the financial statements, auditors should be aware that FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions,* states that the cash flows from hedging transactions should be classified as operating cash items in the statement of cash flows and disclosed as a separate line item if material.

Restructuring Charges

For a number of reasons, including economic conditions and disappointing operating results in recent years, many oil and gas producers are continuing to restructure their operations. In evaluating the propriety of accounting for restructurings, auditors should be aware that restructuring charges should include only costs that are a direct result and an integral part of the restructuring decision and that such charges should be presented as a separate component of income from continuing operations, if material. Restructuring charges typically do not relate to the disposal of a segment of a business, as defined in Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* nor do they qualify as extraordinary items as defined in accounting literature. SEC Staff Accounting Bulletin No. 67 sets forth the view of the SEC staff regarding the presentation of restructuring charges by publicly traded companies.

Innovative Financing Arrangements

Over the past several years, there has been a slow deterioration in the domestic oil and gas industry and a move toward international expansion. Much of the international expansion is being funded through a redirection of operating cash flows away from domestic programs and into international programs. The more traditional flows of investment capital in the industry through direct investments, partnerships, and joint ventures with industry partners have all but disappeared. Many companies that are already highly leveraged are forced to seek other sources of cash flows to fund domestic and foreign operations. Since current sources of external capital funding are generally tight, much of the capital flowing into the industry is being supplied by insurance companies, international money banks, pension funds and foreign investors. Because of various tax considerations and concern over high balance-sheet debt levels, and to meet the objectives of other corporate strategies, many innovative transactions are being considered as a means of attracting capital. The accounting for such transactions may not be covered by or addressed specifically in existing authoritative literature. These transactions may involve off-balance-sheet financing, special purpose entities, and related questions about consolidation policies and variations to existing literature on mineral conveyances. Auditors should carefully evaluate the substance of such transactions as they assess the propriety of the accounting treatment of and financial statement disclosures related to them.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

The AICPA Audit and Accounting Guide *Audits of Entities with Oil and Gas Producing Activities* is available through the AICPA's loose-leaf subscription services. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.

Oil and Gas Producers' Financial Reporting Checklist

The AICPA's Technical Information Service has published a revised version of *Checklists and Illustrative Financial Statements for Oil and Gas Producers* as a tool for preparers and reviewers of financial statements of oil and gas producers. Copies may be obtained by calling the AICPA Order Department.

Technical Practice Aids Publication

Technical Practice Aids is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. *Technical Practice Aids* contains questions and answers specifically pertaining to oil and gas producing entities. *Technical Practice Aids* is available both as a subscription service and in hardback form. Order information may be obtained from the AICPA Order Department.

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This Audit Risk Alert supersedes *Oil and Gas Industry Developments—1991.*

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1992*, which was printed in the November 1992 issue of the *CPA Letter*.

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 862-4272. Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.